1992

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Recommended Citation

Randal C. Picker, "Voluntary Petitions and the Creditors' Bargain," 61 University of Cincinnati Law Review 519 (1992).

VOLUNTARY PETITIONS AND THE CREDITORS' BARGAIN

*Randal C. Picker**

One of the most notable features of United States bankruptcy law is the relative ease with which a debtor can invoke the protection of the bankruptcy court. Typically, the debtor need do no more than pay the appropriate filing fee and sign the petition. The debtor need not be insolvent, and in fact, there has been substantial doubt on this issue in some of our best-known bankruptcies.[1] Nor must the debtor make the substantive showing that creditors filing an involuntary petition typically must make—that the debtor is not paying its debts as they become due[2] or perhaps that the debtor cannot pay its debts as they become due, given how readily manipulable a "not paying" requirement would be for voluntary filings. This is not to say that debtors file casually. The consequences of filing for the debtor and its managers are often substantial and there is every reason to believe that most filings are made only after much deliberation. My point is only that once the debtor has concluded that filing is sensible, very little stands in the way.

Section 109 of the Bankruptcy Code defines who may be a debtor and in doing so suggests the range of possible hurdles that a debtor might be forced to overcome to file. A debtor seeking to file under the (so far) little-used Chapter 9—the bankruptcy chapter for municipalities—must show under § 109(c) that it is insolvent and that, in most cases, it has either successfully negotiated a deal with creditors, has negotiated with such creditors in good faith and has been unable to reach a deal, or cannot negotiate with such creditors because such negotiation would be impracticable.[3] This is a fairly substantial showing: insolvency must be shown and prepetition workout efforts are directly relevant.

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1. *See In re* Johns-Manville Corp., 36 B.R. 727, 730 (Bankr. S.D.N.Y. 1984). Shareholders in the A.H. Robbins bankruptcy received stock worth hundreds of millions of dollars. *See In re* A.H. Robbins Co., 88 B.R. 742, 751 (E.D. Va. 1988), *aff'd*, 880 F.2d 694 (4th Cir. 1989); *see also* DOUGLAS G. BAIRD & THOMAS H. JACKSON, CASES, PROBLEMS, AND MATERIALS ON BANKRUPTCY 183 (2nd ed. 1990).

2. 11 U.S.C. § 303(h)(1) (1988). All subsequent statutory citations will be to the Bankruptcy Code, 11 U.S.C. §§ 1-151326 (1988), unless otherwise indicated.

3. 11 U.S.C. § 109(c)(3), (5). Outside of the United States, insolvency is commonly required. *See generally* Symposium, *Circumstances in Which Proceedings of Bankruptcy/Winding-up May be Initiated in Denmark, Germany, Italy, Norway and the United States*, 10 INT'L BUS. LAW. 31 (1982).

There is a striking difference between the requirements for the run-of-the-mill debtor and a municipality. Although the Bankruptcy Code does confer on the judge the power to abstain or dismiss cases when doing so would be in the best interest of creditors and the debtor,[4] and while a broader requirement of good faith in filing might be found in the Code,[5] it is probably fair to say that §§ 109 and 301 of the Bankruptcy Code give the ordinary debtor a virtually unlimited right to file a voluntary petition.

This is somewhat surprising given its consequences. We have a rich nonbankruptcy insolvency law. (This is true, even if one ignores, as I will, the entirely separate failure rules applicable to certain special firms, such as banks, S&Ls, and insurance companies.)[6] State law may, through statute or judicial creation, provide an assortment of winding-up devices. Receiverships, assignments for the benefit of creditors, compositions, and other similar devices are available under state law to sort out the claims against the failing firm. Other state laws are peculiarly relevant to insolvency, even if they do not purport to address the full range of claims against the firm. State fraudulent conveyance laws, such as the various enactments of the Uniform Fraudulent Conveyance Act and the Uniform Fraudulent Transfer Act, create rules that matter only when a firm has failed. This is true also of alter ego doctrines—that is, rules that treat the corporation and its owners as alter egos and thereby make the owners liable for what would otherwise be corporate debts[7]—and their close cousins—and is also true of the occasional corporate statute that makes shareholders liable for specified categories of the firm's debts.[8] These laws become relevant only when the firm fails. Yet, filing for bankruptcy largely displaces state insolvency law. The receiverships and the like that would otherwise apply do not. Individual actions of creditors against the debtor under state fraudulent

4. 11 U.S.C. § 305.

5. *See* Lawrence Ponoroff & F. Stephen Knippenberg, *The Implied Good Faith Filing Requirement: Sentinel of an Evolving Bankruptcy Policy*, 85 Nw. U. L. REV. 919 (1991).

6. Entities for which other well-developed insolvency regimes exist have traditionally been excluded from the federal bankruptcy law. *See* 11 U.S.C. § 109(b), (d). For a historical discussion, see Michael I. Sovern, *Section 4 of the Bankruptcy Act: The Excluded Corporations*, 42 MINN. L. REV. 171, 172-82 (1957). Whether an alternative insolvency regime exists still plays an important role in determining whether unusual entities will be permitted to file under the Bankruptcy Code. *See, e.g.*, Cash Currency Exch., Inc. v. Shine, 762 F.2d 542, 551-52 (7th Cir. 1985).

7. For a more extended development of these doctrines, see Mark L. Prager & Jonathan A. Backman, *Pursuing Alter-Ego Liability Against Non-Bankrupt Third Parties: Structuring a Comprehensive Conceptual Framework*, 35 ST. LOUIS U. L.J. 657 (1991).

8. *See, e.g.*, N.Y. BUS. CORP. LAW. § 630 (McKinney 1986) (making ten largest shareholders of closed corporations liable for salaries of certain employees).

conveyance laws are stayed by the filing, the trustee can assert these rights under § 544(b), and, in most cases, only the trustee can do so.[9]

Given all of this, a fundamental, but surprisingly, largely unexplored question is presented: Why should we allow voluntary petitions?[10] Assuming we should, how should we structure our legal rules to induce filings by the right firms at the right times? In pursuing these questions, I want to separate flesh-and-blood human beings from entities that exist by the grace of the state. The topic of the symposium—Contemporary Issues in Bankruptcy and Corporate Law—demands it, but this would be the natural dividing line anyhow. The idea of the fresh start gives content to much of the jurisprudence for individual debtors in bankruptcy.[11] This idea is largely, if not completely, irrelevant for corporations and other business entities: we can always get another corporate charter if we need one, and we should therefore put no weight on rehabilitating any particular one. (That idea should be understood to be separate from preserving the going concern value of a business, if any. Preserving a collection of assets is very different from preserving the particular entity controlling those assets.) Given this basic difference between individuals and other entities, I will put to one side the merits of allowing individuals to file voluntarily and will instead consider this question for other entities. I will usually call these "firms."

The idea that firms should not be allowed to file voluntary petitions may sound odd, but of course it harkens to the early days of bankruptcy in England and this country. The idea of voluntary

9. *See, e.g.*, Flip Mortgage Corp. v. McElhone, 841 F.2d 531, 539 (4th Cir. 1988); Palatine Nat'l Bank v. Strom (*In re* Strom), 97 B.R. 532, 539 (Bankr. D. Minn. 1989).

10. One recent article did confront these questions. *See* Douglas G. Baird, *The Initiation Problem in Bankruptcy*, 11 INT'L REV. L. & ECON. 223 (1991). For a historical overview of voluntary petitions, see John C. McCoid, II, *The Origins of Voluntary Bankruptcy*, 5 BANKR. DEV. J. 361 (1988), and for criticisms of the circumstances under which voluntary petitions are filed, see Frank R. Kennedy, *Creative Bankruptcy? Use and Abuse of the Bankruptcy Law—Reflection on Some Recent Cases*, 71 IOWA L. REV. 199 (1985). Somewhat surprisingly given the numbers, both the theory of and practical issues raised by involuntary petitions have received more attention. *See* John C. McCoid, II, *The Occasion for Involuntary Bankruptcy*, 61 AM. BANKR. L. J. 195 (1987); Lawrence Ponoroff, *Involuntary Bankruptcy and the Bona Fides of a Bona Fide Dispute*, 65 IND. L.J. 315 (1990); Eric J. Taube, *Involuntary Bankruptcy: Who May be a Petitioning Creditor?*, 21 HOUS. L. REV. 339 (1984); J. Ronald Trost, *Involuntary Bankruptcy: Pleading and Discovery Problems*, 22 BUS. LAW. 1207 (1967); James C. Van Horne, *Optimal Initiation of Bankruptcy Proceedings by Debt Holders*, 31 J. FIN. 897 (1976).

11. For a discussion of these issues, see DOUGLAS G. BAIRD, THE ELEMENTS OF BANKRUPTCY 24-54 (1992); Thomas H. Jackson, *The Fresh-Start Policy in Bankruptcy Law*, 98 HARV. L. REV. 1393 (1983).

bankruptcy was not introduced in England until 1825.[12] The first federal bankruptcy statute in the United States, the Bankruptcy Act of 1800,[13] allowed only involuntary bankruptcy,[14] and it was not until 1910 that corporations could be brought before the bankruptcy court, voluntarily or involuntarily.[15] Thus, the notion that a firm might be denied the right to file voluntarily, or perhaps to be denied access to a federal proceeding in its entirety, is one worth considering.[16]

I want to shelve—at least temporarily—an expedient answer, namely that if we allow involuntary bankruptcy petitions we may as well allow voluntary petitions, as we will be unable to separate one from the other. A friendly creditor can be found—or paid—to put the debtor in bankruptcy. This problem bedeviled the early bankruptcy statutes,[17] and there is little doubt that enforcing a bar to voluntary bankruptcies will take some work. Given the difficulties of policing the line between voluntary and involuntary bankruptcies, it is worth examining whether there is any reason to keep firms from filing voluntarily.

I will focus on the relationships among the creditors of a typical business firm. I suggest that the stylized deal defined by the relevant United States bankruptcy and debtor-creditor statutes has two central characteristics. First, secured creditors are entitled to first priority to the debtor's assets to the full extent of their security interest (subject, of course, to no more than payment in full) prior to any payment to unsecured creditors. Second, unsecured creditors are entitled to any value in excess of that necessary to pay secured creditors—again subject to no more than payment in full—and this value is to be divided among the unsecured creditors on a pro rata basis.

Unfortunately, this deal is not self-enforcing. In particular, a real risk exists that the secured creditor might cheat on the deal and grab the extra incremental value when it goes to enforce its security interests. As a group, the unsecured creditors face standard collective action problems in enforcing their rights. Enforcing the deal with

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12. *See* GARRARD GLENN, THE LAW GOVERNING LIQUIDATION 136 (1935).

13. Act of April 4, 1800, 2 Stat. 19.

14. *Id.* § 2. For discussion of the history behind this statue, see CHARLES WARREN, BANKRUPTCY IN UNITED STATES HISTORY 12-22 (Harvard Univ. Press 1935) (1972).

15. *See generally* GLENN, *supra* note 12, at 136-40.

16. As is the idea that we might want to allow corporations to elect in their charters whether or not to be eligible for bankruptcy. *See* Robert K. Rasmussen, *Debtor's Choice: A Menu Approach to Corporate Bankruptcy*, TEX. L. REV. (forthcoming 1992) (manuscript at 36-46).

17. *See* WARREN, *supra* note 14, at 20.

the secured creditor redounds to the benefit of all of the unsecured creditors, but each unsecured creditor might seek to freeride on the efforts of other unsecured creditors. These collective action problems would be daunting alone, but they are compounded by informational problems. Enforcing the deal between the secured creditors and the unsecured creditors turns on knowing whether the value of the assets subject to the security interest exceeds the size of the loan. To put this in the economic jargon of the day, the unsecured creditors face a state verification problem: they don't know which state of the world has occurred.[18] Consider a firm with a secured debt of $100 and unsecured debts totaling $100. The assets may be worth less than the amount of the secured debt, say, $80, or they may be worth more, say, $150. In both cases, the firm would be insolvent, but the unsecured creditors would be ignorant of the relevant state. The unsecured creditors may be able to acquire that information, but that will be costly, and there is a substantial risk that unsecured creditors will duplicate each other's efforts if they proceed separately.

The debtor may know this value. The debtor will often, though not necessarily always, have better information than the creditors about the value of the assets. Given the debtor's informational advantage and the possibility of duplicative information expenditures, the creditors as a group would want to enlist the services of the debtor in helping to enforce the bargains among the creditors. Unfortunately, unless payoffs to the debtor are specifically tied to providing the relevant information, there is good reason to think that the debtor will be indifferent about doing so. In the situations relevant to bankruptcy law, the debtor will be insolvent and will not care about whether the deal between secured and unsecured creditors is enforced.

We can make the debtor care, even when its equity interest has ceased to be valuable. The debtor must be induced to provide the critical information about the state of the firm (or, equivalently, be allowed to sell the information in the marketplace). This could be done through a penalty scheme, as occurs in the United Kingdom and Germany[19] or through a bonus scheme.[20]

18. The role of state verification problems in the choice of the capital structure was first considered in Robert Townsend, *Optimal Contracts and Competitive Markets with Costly State Verification*, 21 J. ECON. THEORY 265 (1979). The current state of this literature is usefully summarized in Milton Harris & Artur Raviv, *Financial Contracting Theory*, in ADVANCES IN ECONOMIC THEORY (Jean-Jacques Laffont ed., 1992) (prepared for Sixth World Congress (Aug. 22-28, 1990)).

19. *See infra* notes 71-74 and accompanying text.

The United States has chosen the latter. The Bankruptcy Code contains a powerful mechanism that should induce the debtor to enforce the creditors' bargain. The debtor's right to file a voluntary petition and to invoke the holdup power conferred on the debtor by the automatic stay[21] and the exclusivity period[22] operates as a mechanism for compensating the debtor for filing a voluntary petition. The right of the secured creditor under § 362(d) of the Bankruptcy Code to seek to lift the stay can be used to sort out appropriate cases that should and should not be in bankruptcy.[23] The petition has the effect of resulting in better enforcement of the creditors' bargain than would be possible in a world in which only involuntary petitions were permitted.[24]

Although this view, if correct, seems worthwhile in explaining the relatively unexplored question of the merits of voluntary filings, it also helps provide a foundation for recent work exploring the effects of the automatic stay. In theoretical work, recent developments in bargaining theory have been used to explore formally the effect of the automatic stay/exclusivity period on the division of the value of the failed firm.[25] Unsurprisingly, this work suggests that the automatic stay and the exclusivity period transfer value to shareholders. And the recent empirical work on the absolute priority rule confirms this.[26] The theoretical and empirical work has left relatively unexamined the merits of this transfer. This article suggests that the

20. Tom Jackson has noted the possible role of bonuses in filing. *See* THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW 207-08 (1986).

21. 11 U.S.C. § 362.

22. 11 U.S.C. § 1121.

23. Though, in practice, the lift stay motion could do a much better job of doing this. *See infra* notes 60-61 and accompanying text.

24. Much of what I say is applicable to firms that have no secured debt, though I will not focus on those situations. For those firms, the Bankruptcy Code should be designed to enforce the pro rata bargain among the unsecured creditors. The state verification problem that I focus on really exists only as between secured and unsecured creditors.

25. *See* Douglas G. Baird & Randal C. Picker, *A Simple Noncooperative Bargaining Model of Corporate Reorganizations*, 20 J. LEGAL STUD. 311 (1991); Lucian A. Bebchuk & Howard Chang, *Bargaining and the Distribution of Value in Corporate Reorganization*, 8 J.L. ECON. & ORGANIZATION 253 (1992); *see also* Yaacov Z. Bergman & Jeffrey L. Callen, *Opportunistic Underinvestment in Debt Renegotiation and Capital Structure*, 29 J. FIN. ECON. 137 (1991).

26. *See, e.g.*, Julian R. Francks & Walter N. Torous, *An Empirical Investigation of U.S. Firms in Reorganization*, 44 J. FIN. 747 (1989); Lawrence A. Weiss, *Bankruptcy Resolution: Direct Costs and Violation of Priority of Claims*, 27 J. FIN. ECON. 285 (1990); Lynn M. LoPucki & William C. Whitford, *Bargaining Over Equity's Share in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 139 U. PA. L. REV. 125, 176 (1990); Allan C. Eberhart et. al., *Security Pricing and Deviations from the Absolute Priority Rule in Bankruptcy Proceedings*, 45 J. FIN. 1457 (1990). This work is summarized and extended in Michelle J. White, Measuring Deviations from Absolute Priority in Chapter 11 (April 10, 1992) (unpublished manuscript, on file with author).

transfer of value to the debtor effectuated by the stay provides an appropriate inducement for the debtor to commence voluntary proceedings when it would otherwise not do so.[27]

It may be worthwhile to comment on the methodology of this article. The creditors' bargain approach to bankruptcy dates from Tom Jackson's article *Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain.*[28] In many ways, this article applied the well-known framework of John Rawls for exploring justice[29] to the nitty-gritty questions of debtor-creditor law. This has proved controversial.[30]

Some of that controversy may relate to an ambiguity about the mission of the creditors' bargain approach. Two vantage points, positive and normative, should be kept separate. The creditors' bargain approach might be thought to be *predictive*: someone who understood the approach could predict the content of the Bankruptcy Code. If so, that would save him or her the not insubstantial trouble of actually reading the statute, and, more importantly, would suggest that the statute was supported by a coherent intellectual framework. The creditors' bargain model would then serve as a positive description of the content of the bankruptcy laws.

As is generally conceded, making out the positive case is difficult. There is nothing in the approach which would limit its domain to United States bankruptcy law. Bankruptcy law across countries varies enormously, and variety is a real problem for positive law and economics. *Homo economicus* maximizes as well in the United States as in Afghanistan. If one's business is predicting the content of the law from economic first principles, one had better hope that the law looks fairly similar across the board. At best, differences must be

27. Along with co-authors, I have suggested other reasons to think that this transfer enhances overall social welfare. Lucian Arye Bebchuk and I argue that the violation of absolute priority in bankruptcy improves ex-ante decisionmaking regarding investments for a firm. *See* Lucian A. Bebchuk & Randal C. Picker, Bankruptcy Rules, Managerial Entrenchment and Firm-Specific Human Capital (Nov. 27, 1992) (unpublished manuscript, on file with authors). Robert Gertner and I argue that the deviation from absolute priority creates bargaining power in favor of the debtor and that this improves out-of-bankruptcy decisionmaking about the failing firm's assets and the timing of the bankruptcy petition. *See* Robert Gertner & Randal C. Picker, Bankruptcy and the Allocation of Control (Nov. 27, 1992) (unpublished manuscript, on file with author).

28. Thomas H. Jackson, *Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain*, 91 YALE L.J. 857 (1982). For a reformulation of Jackson's view, see Thomas H. Jackson & Robert E. Scott, *On the Nature of Bankruptcy: An Essay on Bankruptcy Sharing and the Creditors' Bargain*, 75 VA. L. REV. 155 (1989).

29. JOHN RAWLS, A THEORY OF JUSTICE (1971).

30. *See* David G. Carlson, *Bankruptcy Theory and the Decline of the Creditors' Bargain*, 61 U. CIN. L. REV. 453 (1992); David G. Carlson, *Philosophy in Bankruptcy*, 85 MICH. L. REV. 1340 (1987) (reviewing THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW (1986)).

described as two ways of achieving the best of all possible worlds, as when the function f(x) may take on the same maximum value at two different points x_1 and x_2. Making even one country's bankruptcy statute fit is hard work; getting them all in may be next to impossible.

Alternatively, the creditors' bargain approach might be understood as a normative lens. On that view, the bankruptcy law *should*, but not necessarily will, reflect the actual bargain that would be struck. Rather than predicting the content of any given country's law, the content of the creditors' bargain would then suggest a blueprint for reform of the bankruptcy laws. An economist would term this an "ex ante optimal contracting approach" to bankruptcy, and I will use this phrase to describe the normative part of the creditors' bargain approach. This is quickly becoming an important approach to analyzing bankruptcy law.[31] That approach might suggest that bankruptcy laws should set out as default rules the contract that the parties themselves would negotiate.[32] I will not address that issue here, but will instead discuss what I see as the key elements of the current legal regime and the role that voluntary petitions play as part of that regime.

This paper is divided into four sections. Section I is purely descriptive. It sets out in some detail the basic contours of the deal between secured and unsecured creditors and among the unsecured creditors group. Using the term "deal" is consistent with the optimal contracting approach to bankruptcy theory but should not be understood literally. Most of the deal is reflected in the applicable statutory framework. Section II focuses on how the Bankruptcy Code implements these deals, at least in part. It justifies voluntary petitions by debtors and also explains why it is important to set aside value for the debtor in bankruptcy. Section III offers criticisms of the analysis and suggests alternatives and extensions. Section IV concludes the paper.

31. I have used this approach in Bebchuk & Picker, *supra* note 27; Gertner & Picker, *supra* note 27; Randal C. Picker, *Security Interests, Misbehavior, and Common Pools*, 59 U. CHI. L. REV. 645 (1992). It can also be found in Barry E. Adler, *Bankruptcy and Risk Allocation*, 77 CORNELL L. REV. 439 (1992); Rasmussen, *supra* note 16; Lucian A. Bebchuk, The Effects of Chapter 11 and Debt Renegotiation on Ex Ante Corporate Decisions (August, 1991) (unpublished manuscript, on file with author); Alan Schwartz, Bankruptcy Workouts and Debt Contracts (1992) (unpublished manuscript, on file with author); and almost surely elsewhere.

32. Or it might not. *See* Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87 (1989) (arguing that strategic concerns may suggest default rules designed to facilitate information transmission).

I. The Deals Struck

The respective rights of secured and unsecured creditors can be understood only if three separate and sometimes complex bodies of law are understood: state execution and collection laws; state laws for voluntarily creating liens, meaning real estate mortgage laws and the adopted version of Article 9 of the Uniform Commercial Code; and federal bankruptcy laws, as set forth primarily in title 11 of the United States Code.[33] Together, these laws define the rules applicable to debtors and creditors inside and outside of bankruptcy. It is of critical importance to understand the rights applicable outside of bankruptcy, those in bankruptcy, and what controls the choice of the two regimes.

Start with the regime applicable outside of bankruptcy. These laws are well-known for their intricacy, but for my purposes three central elements stand out:

> 1. *Special Contractual Collection Rights.* Pursuant to a contract, creditors may acquire special collection rights against the debtor. These rights often entail the right to seize property without judicial process[34] and, in the case of individuals, may make property available to the creditor that it would otherwise be barred from seizing.[35]
>
> 2. *Special Contractual Priority Rights.* Priority rights can be created pursuant to contract. These define rights as among equityholders—for example, the rights of preferred stock against common stock; rights between equity and debt; and rights among different types of debt. As to the latter, creditors may acquire special priority rights against their fellow credi-

33. This discussion omits the Debt Collection Act of 1982, Pub. L. No. 97-365, 96 Stat. 1749 (1982), and other federal laws that might be relevant to debtor-creditor issues. It also omits discussion of statutory liens under state law, such as landlord's liens and mechanics' liens, and under federal law, such as tax liens, *see, e.g.*, 26 U.S.C. § 6321 (1988); environmental liens, *see, e.g.*, 42 U.S.C. § 9607 (1988); and pension liens, *see, e.g.*, 29 U.S.C. § 1368 (1988).

34. *See* U.C.C. § 9-503 (1992) ("Unless otherwise agreed a secured party has on default the right to take possession of the collateral. In taking possession a secured party may proceed without judicial process if this can be done without breach of the peace or may proceed by action . . . .").

35. *See* 11 U.S.C. §§ 522(c)(2), 522(f)(2) (1988) (enforcing all possessory liens, purchase money liens and certain nonpossessory, nonpurchase money liens). The applicable laws often impose substantial limits. These may go to the form for obtaining rights against otherwise exempt property. Typically, such property is made available to a creditor by granting a security interest and a simple waiver in favor of an unsecured creditor is ineffective. *See* 11 U.S.C. § 522(e). Or, the limits may go to substance, as § 522 allows the debtor to avoid a broad category of nonpossessory, nonpurchase money liens. Also, the taking of such a lien constitutes an unfair practice under 16 C.F.R. 444.2. *See, e.g.*, Robert Scott, *Rethinking the Regulation of Coercive Creditor Remedies*, 89 COLUM. L. REV. 730, 747 (1989).

tors. These may be rights of one creditor as against a particular group of creditors, as would occur pursuant to a subordination agreement. This would be an explicit deal among creditors.[36] In other cases, pursuant to a contract and a public recording, an Article 9 security interest or a real estate mortgage confers priority rights against all unsecured creditors and against later secured creditors.[37]

3. *Priority Through Involuntary Acts.* Creditors who have not obtained contractual collection rights or priority rights may acquire priority over other similarly situated creditors through involuntary acts taken with regard to a debtor's property. Most often, this still requires delivery of an execution to the sheriff or seizure of property,[38] though a number of states now allow creditors to achieve priority through notice filing.[39] State execution and collection laws for unsecured creditors typically confer priority as among the unsecured creditors based upon the date of seizure. State seizure law is grab law, first-come, first-served.[40] These largely unsecured creditors stand on equal-footing: each can race to the assets to pursue priority.

As already noted, a bankruptcy petition substantially alters the way in which these out-of-bankruptcy rights are implemented. And, given the ease with which debtors may file voluntary petitions and their incentives to do so given the repeated deviations from absolute priority, the deal among the secured creditors, the unsecured creditors and the debtor must be understood in the light of how the rights described above carry over into bankruptcy:

1. *The Automatic Stay and Special Collection Rights.* The special collection rights of the secured creditor are largely illusory. This would be true even without the automatic stay. Under section 9-503 of the Uniform Commercial Code, the secured creditor can repossess without judicial process only if it can do so without a breach of the peace. The latter phrase has been interpreted quite narrowly,[41] sufficiently so that only the

36. And one that the law generally permits. *See* 11 U.S.C. § 510(a); U.C.C. § 9-316 (1992).

37. *See, e.g.*, U.C.C. §§ 9-301, 9-312(5).

38. *See, e.g.*, N.Y. CIV. PRAC. L.& R. 5234(b) (Consol. 1978).

39. For a description of the new execution laws and a discussion of their implications, see William J. Woodward, Jr., *New Judgment Liens on Personal Property: Does "Efficient" Mean "Better"?*, 27 HARV. J. ON LEGIS. 1 (1990) (arguing that while new state execution statutes will be more efficient, total system costs may be greater).

40. *See, e.g.*, N.Y. CIV. PRAC. L. & R. § 5234.

41. *See, e.g.*, Stone Mach. Co. v. Kessler, 463 P.2d 651,655 (Wash. Ct. App. 1970); Salisbury Livestock Co. v. Colorado Central Credit Union, 793 P.2d 470, 474-76 (Wyo. 1990).

most aggressive secured creditor will rely on section 9-503 alone to take possession of property. Beyond this, bankruptcy's automatic stay largely eliminates whatever remaining force section 9-503 might have. Simply by filing, the debtor can prevent the secured creditor from seizing property.

2. *Deviations from Absolute Priority*. As already noted, one of the most consistent results in our limited empirical database regarding bankruptcy is that out-of-bankruptcy priority is only partially respected in bankruptcy.[42] Put more succinctly, absolute priority is not: shareholders routinely receive value notwithstanding the fact that creditors are not paid in full. The creditors as a group are willing to pay off equityholders to relinquish the control conferred on them by the automatic stay and the exclusivity period. Most of these deviations appear to come at the expense of unsecured, rather than secured, creditors.

3. *Preferences and Pro Rata Sharing*. In bankruptcy, general unsecured creditors share value pro rata.[43] The ability of an unsecured creditor to acquire priority through seizure of assets prior to bankruptcy is substantially limited by the trustee's right to recover preferences.[44] Although the defenses to a preference are broad, only rarely, if ever, will seizure by an unsecured creditor qualify under § 547(c).[45] This recovery of prepetition seizures protects the basic rule of pro rata distributions for unsecured creditors.

Note well how these basic elements interact. The rights of both secured and unsecured creditors to seize property are severely circumscribed by built-in limitations under applicable state law, such as section 9-503, and by the force of the automatic stay and preference provisions of the Bankruptcy Code. Outside of bankruptcy, the unsecured creditors are on par with each other and this is directly carried over in bankruptcy under the pro rata distribution rule. The essential characteristics of the creditors' bargain, if reflected in current law, thus emerge as priority for secured creditors to the extent of their security and equality among unsecured credi-

42. *See supra* note 26.

43. 11 U.S.C. § 726(b).

44. 11 U.S.C. § 547.

45. *See, e.g.*, Peterson v. Chas. Bender Co. (*In re* Lifchitz), 131 B.R. 827,835 (Bankr. N.D. Ill. 1991); *In re* Veteran Plate Glass Co., 71 B.R. 74 (Bankr. N.D. Ohio 1987). There are other rights that are important—rights as between creditors and third parties and rights as among secured creditors, especially for creditors receiving purchase money security interests, but I will not pursue them here. For one treatment, *see* Alan Schwartz, *A Theory of Loan Priorities*, 18 J. LEGAL STUD. 209 (1989) (treating choice of order of distribution as optimal contracting problem).

tors for the residual.[46] The most important way in which the Bankruptcy Code's distributions deviate from the distributions provided for outside of bankruptcy is the consistent transfer from unsecured creditors to equityholders. Whether there is anything to be said for that result is considered in the next section.

II. VOLUNTARY PETITIONS AS AN ENFORCEMENT MECHANISM

Consider the situation set out in the following figure:

Corporation A

State	Project *Probability*	*Value*		
			Secured Creditor:	$100
			Unsecured Creditors	
			10 @ $10 =	$100
S1	0.50	$300		
S2	0.25	$120	Total Debts	$200
S3	0.25	$100		
Expected Value =		$205		

This is obviously *highly* simplified, but should suffice to capture the problem. Consider a corporation, ACorp, Inc. ACorp has a single widget project and the project has three possible outcomes. In the good state, S1, the project is a great success and is worth $300. This is expected to happen 50% of the time. Of course, the project may fail, too. In the first bad state, state S2, the project is worth $120. This happens 25% of the time. Finally, in the second failure outcome, state S3, the project is a complete bust and is worth only $100. This happens 25% of the time.

In addition to the single project, ACorp has a very simple debt structure. It has a single secured creditor owed $100 with a perfected, prior security interest in the firm's sole asset, the widget project. In addition, the firm has unsecured debts totaling $100 comprised of ten separate debts of $10. The firm therefore has total debts of $200 matched with the project. For the given probabilities and the associated values, the project's expected value is $205.[47]

46. I have argued elsewhere that security interests play an important role in allocating monitoring of the debtor and eliminating needless monitoring of creditors. *See* Picker, *supra* note 31, at 650. There is every reason to think that security interests would be part of an explicit bargain among the creditors. The same is true of unsecured debt, though it is far from obvious that it would have all of the characteristics associated with current unsecured debt. *See id.* at 647 n.6.

47. $(.50 \times 300) + (.25 \times 120) + (.25 \times 100) = 150 + 30 + 25 = 205$.

Based on these figures, prior to running the project and determining the outcome, the firm is solvent.

Consider how this situation plays out in a world of perfect information. If the project is a success—meaning that state S1 occurs—the creditors will be paid in full. The firm be worth enough to pay the creditors and the creditors will know this. The equityholders of the firm will then hold stock worth $100. If the project fails completely—meaning that state S3 occurs—the contractual priority of the secured creditor would be enforced. The secured creditor would simply get the full $100 in value, and none of the unsecured creditors would receive anything. Again, given the assumption of perfect information, there is no difficulty reaching this outcome. And, if the project fails but not completely—meaning S2 occurs—the secured creditor would still receive payment in full, but each unsecured creditor would get its pro rata portion—recall § 726(b) of the Bankruptcy Code—of the remaining $20, or $2.

All of this is simple and straightforward. With full information about the firm's value, the agreed upon division of value among the equityholders, the unsecured creditors, and the secured creditors is implemented as per the agreement. No one can deviate from the prearranged split, as it is costless to enforce it.

Reality, though, is uncertainty. The creditors do not know, without more, which state of the world has occurred, but in some situations, the debtor may convey some information about the status of the project. If the project is a success, the creditors will probably get checks in the mail on time, and therefore a simple signal by the debtor—payment in full, on time—makes it easy for the creditors to distinguish state S1 from states S2 and S3.[48] But if one of states S2 or S3 occurs, no check may arrive. The debtor will be insolvent, and without more, will have no stake in how its assets are divvied up among its creditors. The debtor may pay particular creditors or it may simply abandon ship. It will not necessarily send *any* signal that will inform the creditors of the relevant state of the world.

The consequences of not knowing whether state S2 or S3 has occurred are substantial. The most likely course is that the secured creditor will take action against the project under its state law de-

48. Note that this simplifies and does so fairly dramatically. There is a well-developed literature in capital theory which takes as its jumping off point that borrowers, without more, will not even necessarily make payments even if they have the funds to do so. Financial instruments then must be designed to induce the firm to make voluntary payments when it can do so. *See, e.g.*, Douglas Gale & Martin Hellwig, *Incentive-Compatible Debt Contracts: The One-Period Problem*, 52 REV. ECON. STUD. 647 (1985).

fault rights. The secured creditor knows that, regardless of whether bad state S2 or S3 occurred, it is entitled to first crack at the assets. In this situation, the concern should be that the secured creditor will breach its agreement with the unsecured creditor group. It may do that by selling the assets for $100 when they are actually worth $120. Since the secured creditor must remit to the debtor any excess sale price,[49] it may not exert any efforts to receive full value for the sold property, if that value exceeds the amount of the debt.

The secured creditor also might behave opportunistically and seek to pocket the excess value. The secured creditor might do this by trying to retain the collateral in satisfaction of its debt.[50] Notice to the debtor may be required, but given the debtor's insolvency, there may be little reason for the debtor to care about the retention. There may be no other secured creditors entitled to notice of the retention, and unsecured creditors are generally not entitled to notice,[51] and may have no standing to object even if they were to get wind of the retention.[52] The debtor may be indifferent to all of this. These issues influence how the insolvent firm's assets are divided among its many creditors, but these issues do not result in value being made available to the debtor.

Alternatively, the secured creditor may purchase the property at a sale conducted under UCC section 9-504 and resell it for a higher price.[53] Attendance at public sales is notoriously spotty,[54] and nothing in section 9-504's standard of commercial reasonableness requires that the secured creditor receive the best price possible.[55] The secured creditor may very well have private information about

49. U.C.C. § 9-504(2) (1992).

50. U.C.C. § 9-505(2) (1992).

51. *See, e.g.*, Michel v. J's Foods, Inc., 661 P.2d 474, 477 (N.M. 1983).

52. *See, e.g.*, Peerless Packing Co. v. Malone & Hyde, Inc., 376 S.E.2d 161, 165-66 (W. Va. 1988). One might contend that retaining collateral with a value in excess of the debt amounts to a fraudulent conveyance. This would give rise to an independent basis to challenge the transaction after the fact, even if the creditors lacked standing under U.C.C. § 9-505 to challenge the retention itself. As a general matter, procedural compliance with foreclosure statutes will not insulate a transfer from a fraudulent conveyance act. Durrett v. Washington Nat'l Ins. Co., 621 F.2d 201, 204 (5th Cir. 1980), is the best-known case to so hold. There seems to be very little case law examining this question regarding § 9-505 retentions, but that which exists casts doubt on whether they would be found to be fraudulent. *See J's Foods*, 661 P.2d at 476.

53. *See* Bank of Chapmanville v. Workman, 406 S.E.2d 58, 61 (W. Va. 1991).

54. It is easy to find reported cases in which only one or two possible buyers appeared at the sale. *See, e.g.*, *In re* Whatley, 126 B.R. 231, 234 (Bankr. N.D. Miss. 1991); First Interstate Credit Alliance, Inc. v. Clark, 11 U.C.C. Rep. Serv. 2d 1017, 1018 (Callaghan) (S.D.N.Y. 1990); Credit Alliance Corp. v. Concord Coal Corp., 81 B.R. 863, 864 (S.D. W. Va. 1988).

55. *See also* U.C.C. § 9-507 (1992) ("The fact that a better price could have been obtained by a sale at a different time or in a different method from that selected by the

the assets that will allow it to sell them for a higher price even after it conducts a qualifying sale.[56] This in fact may be the preferred route for the secured creditor, as unlike retention under section 9-505, the secured creditor can pursue the debtor for a deficiency after a sale under section 9-504.[57] The possibility of retention under section 9-505 or sale, purchase, and resale under section 9-504 places the original deal for dividing the assets between the secured creditor and the unsecured creditors at risk.

Given all of this, to return to the example, the unsecured creditors can have little assurance that they will receive, without some effort, the $20 to which they are entitled if state S2 rather than S3 occurred. How will the unsecured creditors respond to the uncertainty over which bad state has occurred? As a group, they have as much as $20 at stake, though the expected amount at stake is only $10.[58] If we assume (for now) that the unsecured creditors could perfectly enforce their deal with the secured creditor once they had learned the debtor's status, they would be willing to spend up to $10 to acquire that information.

The unsecured creditors, though, do not proceed as a group, and the real question is how the individual unsecured creditors will proceed. To answer this question, focus on how the benefits and burdens of the information acquisition—the monitoring, for short—will be divided. It seems that both undermonitoring and overmonitoring are possible. First consider rules that provide for each unsecured creditor to bear its own costs of monitoring and that further provide for the benefits of monitoring to be divided pro rata. For

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secured party is not of itself sufficient to establish that the sale was not made in a commercially reasonable manner.").

56. In *In re* Whatley, 126 B.R. at 231, the secured creditor purchased at the § 9-504 sale for $25,000, and resold it, at auction, *the following day*, for net proceeds of $39,748.29.

57. *See* U.C.C. § 9-504(2) (1992). This route also may avoid the open question of whether retention under § 9-505 can be a fraudulent conveyance. In response to the perceived problem of *Durrett*, § 3(b) of the Uniform Fraudulent Transfer Act provides that "a person gives a reasonable equivalent value if the person acquires an interest of the debtor in an asset pursuant to a regularly conducted, noncollusive foreclosure sale or execution of a power of sale for the acquisition or disposition of the interest of the debtor upon default under a mortgage, deed of trust or security agreement." As more states switch from the UFCA to the UFTA, § 3(b) will offer greater protection for complying § 9-504 sales. Note, though, that if such a sale falls within the one-year window given in § 548(a) of the Bankruptcy Code, it will still be subject to avoidance as a fraudulent conveyance, as § 548 lacks the foreclosure sale safe harbor. *See* 11 U.S.C. § 548(a).

58. They know the firm has failed—no check was received—and when the firm fails, 50% of the time, unsecured creditors are entitled to nothing and 50% of the time to $20, giving an expected value of $10.

example, if the cost of monitoring is \$k and only one unsecured creditor monitors and none of the others do, all of the non-monitoring unsecured creditors receive \$2, and the monitoring creditor nets \$2-k, if state S2 has occurred, and \$0 and -\$k respectively if state S1 has occurred.

Two points should be apparent. First, the creditor will not monitor if the cost of monitoring exceeds its expected payoff from monitoring, or if $k > \$1$. Second, each unsecured creditor would rather free ride on the monitoring efforts of another creditor than monitor. Under this regime, if the monitoring costs exceeded the individual creditor's pro rata share of the recovery for each creditor, no creditor would monitor and the secured creditor would be able to capture the value in excess of the amount owed to it. In our simple example, that would occur if $k > \$1$, since that is the expected pro rata benefit from monitoring for each creditor.

Nevertheless, it is very unlikely that this would happen this way. The benefits of monitoring for the unsecured creditors would be divided pro rata only if the monitoring creditor chose to file an involuntary bankruptcy petition. Pro rata division is the rule of § 726(b) of the Code and thus only applies after a proceeding has been commenced. Pro rata division is not the rule that would otherwise be applicable under state law. State law is grab law. The monitoring unsecured creditor will seek payment in full of its debt and may even seek to split some of the excess remaining value with the secured creditor. To return to the example, if the creditor monitors and learns that there is \$20 generally available for the unsecured creditors, the creditor will demand \$10 in payment in full. He may also seek a share of the remaining \$10 by threatening to inform one (and only one) fellow unsecured creditor about the extra money.

Where does this put the unsecured creditors? Individual monitoring is relatively unattractive if the benefit of monitoring is divided pro rata, but that will not happen unless the monitor files a petition in bankruptcy. Since the monitor will not file, monitoring could be profitable and more than one unsecured creditor could wind up monitoring the secured creditor's behavior.

One solution to this might be to allow a special priority in bankruptcy for the costs associated with monitoring whether a petition should be filed, so long as the person seeking the priority actually filed the petition. Nonetheless, this probably would be ineffective because, in many cases, the unsecured creditor will conclude after monitoring that there is no value for the unsecured creditors and that no collective proceeding is appropriate. Unless the unsecured creditor is empowered to assess its fellow unsecured creditors not only when value is there—as it would when it received a monitoring expense priority in the bankruptcy—but when value is not there, there will be undermonitoring of the secured creditor's behavior.

Both undermonitoring and overmonitoring seem possible. In any event, the lowest cost monitor will not be monitoring: the debtor would be the lowest cost monitor of the secured creditor's behavior. As a general matter, the debtor may have the best information about the value of the firm.[59] Given the notice rules in UCC sections 9-504 and 9-505, which fail to require notice to any unsecured creditors, the debtor will surely have the best information about the secured creditor's actions. Given this, the best possible result for the creditors as a group would be to pay the debtor a fee to inform them of whether S2 or S3 has taken place. Recall that that knowledge is essential to enforcing the upfront deals of the creditors. The debtor is the lowest cost monitor of this, but in the absence of a device for channeling value to the debtor (or for penalizing the debtor), the debtor will not care about seeing that the upfront deal is enforced between the secured and the unsecured creditors.

The Bankruptcy Code does this through the debtor's right to file a voluntary petition and through the automatic stay/exclusivity rules. As already noted, §§ 109 and 301 of the Bankruptcy Code give the debtor a virtually limitless right to file a voluntary petition. The debtor's control over the property is created by the automatic stay of § 362, which generally prevents creditors from seizing the debtor's property. It is further enhanced by § 1121 of the Code, which gives the debtor the exclusive right to file a reorganization plan for 120 days, a period which is often extended.

The unsecured creditors want the debtor to file when the value of the project exceeds the amount of the secured creditor's claim, or, to put this in the language of the Bankruptcy Code, when the debtor has equity in the property.[60] In a world where judges value property and businesses accurately, the debtor will do just that. If there is no value available for the unsecured creditors, the debtor will not file. No value available means that the secured creditor's claim exceeds the value of the project, or to put it the other way, that the debtor has no equity in the property. The secured creditor would

59. *See* Lynn M. LoPucki, *The Debtor in Full Control, Systems Failure Under Chapter 11 of the Bankruptcy Code*, 57 AM. BANKR. L.J. 247, 257 (1983); Lynn M. LoPucki & William C. Whitford, Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies 29 (December, 1991) (unpublished manuscript, on file with author). *Compare* Carliss Y. Baldwin & Sugato Bhattacharyya, *Choosing the Method of Sale: A Clinical Study of Conrail*, 30 J. FIN. ECON. 69, 86-87 (1991).

60. *See* 11 U.S.C. § 362(d)(2)(A).

win its lift stay motion, and the debtor will lose its ability to holdup the creditors for value. The debtor will not file. If there is value available to the unsecured creditors—meaning there is an equity in the property—the debtor will survive the secured creditor's lift stay motion, and will therefore file as it will be able to exercise the holdup powers conferred on it through the automatic stay and the exclusivity rule.

This scheme sorts the cases precisely along the dividing line of cases in which value in excess of the debt owed to the secured creditor exists and those in which it does not. If there is no value for the unsecured creditors, the debtor will not file, as it will lose the lift stay motion and will therefore receive nothing through the exclusivity holdup. If there is value for the unsecured creditors, the debtor will win the lift stay motion, and can therefore maintain the exclusivity period. The creditors will buy off the debtor, and therefore the debtor will receive the value that will induce it to file in the first place. This sorting is precisely what is required to enforce the split agreed to between the secured creditor and the unsecured creditors.

This suggests that in many cases deviations from absolute priority can be justified as a bonus for bringing the case in the first place. The bonus is a contingent bonus, and thus avoids the overfiling problem that would be associated with a flat fee or any other mechanism not directly tied to the value of the assets.[61] On this view, the automatic stay operates as a non-waivable means of channeling value to the manager-shareholders that induces them to file voluntary petitions in those situations in which there is value to be distributed to the unsecured creditors. In effect, the unsecured creditors appoint the manager-shareholders as their agent for enforcing the original deal between the secured creditor and the group of unsecured creditors. And the problems with verifying the state of the world—are the assets worth $80 or $150?—that put the deal between the secured and unsecured creditors at risk are squarely presented and answered by coupling the voluntary petition with the lift stay motion.

61. Baird also cautioned against using flat fees to induce filings. *See* Baird, *supra* note 10, at 231. He suggested that managers will file to keep their jobs and that compensation for filing will be paid in the form of salaries during operations in bankruptcy. *See id.* at 230. That result is premised on the view that the managers are being paid more inside the firm than they would be on the outside. That is an empirical question, but the answer is not obvious. *Compare* Baird & Picker, *supra* note 25, at 320 n. 23, 334 n.50. Moreover, this is tempered by the fact that the mere fact of filing probably has a signaling effect that reduces the value of the manager-shareholder's human capital. *See* Robert I. Sutton & Anita L. Callahan, *The Stigma of Bankruptcy: Spoiled Organizational Image and its Management*, 30 ACAD. MGMT. J. 405, 406-07 (1987).

III. Criticisms and Comments

There are a number of open items. Consider these one-by-one. First, a standard problem still exists: who monitors the monitor? When the secured creditor seeks to levy on the property outside of bankruptcy, the debtor could try to cut a deal with the secured creditor and offer to keep the debtor out of bankruptcy in exchange for part of the value the secured creditor obtains by breaching its agreement with the unsecured creditors. There may be reasons to think that this is less problematic here. Even if the debtor cuts a deal with the secured creditor outside of bankruptcy, it will still be left with outstanding unsecured creditors. The value received by the debtor will not be insulated from their claims, and if the unsecured creditors engage in some type of low-grade monitoring, such as engaging a bill collector, they may be able to reach the value given to the debtor by the secured creditor. A bankruptcy proceeding, on the other hand, would almost surely allow the debtor to obtain value that it can keep. The unsecured claims would either be discharged or satisfied through the plan as part of the holdup deal with the debtor.[62]

Second, the analysis probably overstates the success of the current Bankruptcy Code in sorting cases into bankruptcy. The debtor will file anytime that it can withstand the lift stay motion as that is sufficient to get the holdup bonus. Under § 362, the stay will be maintained if the debtor can show that the creditor is adequately protected[63] *or* if the debtor has no equity in the property and it is not needed for an effective reorganization. As this does not focus cleanly on the question of whether there is value for the unsecured creditors, the debtor may file even when there is none. This risk is exacerbated by the decision in *United Savings Ass'n v. Timbers of Inwood Forest Associates, Ltd.*, which held that maintaining the value of the assets of the debtor during the proceeding may suffice as adequate protection.[64] *Timbers* clearly undercuts the ability of the current Bankruptcy Code to sort cases appropriately, as it causes too many petitions to be filed.

Third, nothing said so far helps us quantify how large the deviation needs to be or the precise mechanism for effectuating the transfer. As to the latter, I have suggested that the current procedural rights given to the debtor and largely exercised by management, and in particular the automatic stay and the exclusivity period, allow

62. *See* 11 U.S.C. § 1141.
63. *See* 11 U.S.C. § 361; 11 U.S.C. § 362(d)(1).
64. 484 U.S. 365, 382 (1988).

value to be diverted from unsecured creditors. Nonetheless, identifying the mechanism for the transfer tells us nothing about the size of the transfer required to induce the debtor to play its assigned role. We care about differentials in and outside of bankruptcy for distressed firms: for example, differences in job loss and timing for managers or for the stigma the managers face going forward. As a general matter, managers of distressed firms face a disproportionate risk of job loss.[65] This holds true not only for their current jobs with the filing firm but also for other employment opportunities, such as outside directorships.[66] Beyond this, small-scale studies of Chapter 11 suggest it stigmatizes those associated with the debtor. This is true even of those employees who joined the firm *after* the filing, who should have escaped blame for the firm's predicament.[67] By design, filing for bankruptcy is a very public act, and although we may not be able to quantify the extra loss insiders of distressed firms experience when the debtor files for bankruptcy, it is surely more than de minimis.

Fourth, giving bonuses or "carrots" for filing is only one approach to altering the incentives that manager-shareholders would have for filing. It clearly will work best where managers also hold equity, and thus matters most for private corporations. This covers a large part of the relevant landscape. Cases involving public corporations are exceedingly rare[68] and, more generally, even large cases—say, cases involving more than $100 million in assets—make up less than two percent of the cases in which Chapter 11 plans are confirmed.[69] Even this overstates the presence of large cases, as the probability of confirmation appears to be positively correlated with asset size.[70] Nonetheless, for public corporations, where managers

65. *See* James S. Ang & Jess H. Chua, *Corporate Bankruptcy and Job Losses Among Top Level Managers*, 10 FIN. MGMT., Winter 1981, at 70; Stuart C. Gilson, *Management Turnover and Financial Distress*, 25 J. FIN. ECON. 241 (1989) (stating that 52% of firms in financial distress experience senior management change versus 19% of nondistressed unprofitable firms); Kenneth B. Schwartz & Krishnagopal Menon, *Executive Succession in Failing Firms*, 28 ACAD. MGMT. J. 680 (1985). *Compare* Stuart C. Gilson, *Bankruptcy, Boards, Banks and Blockholders: Evidence on Changes in Corporate Ownership and Control When Firms Default*, 27 J. FIN. ECON. 355 (1990).

66. *See* Ang & Chua, *supra* note 65, at 72.

67. *See* Sutton & Callahan, *supra* note 61, at 406-07.

68. Michael Bradley & Michael Rosenzweig, *The Untenable Case for Chapter 11*, 101 YALE L.J. 1043, 1059-60 (1992), put the figure at well-under one percent both before and after the enactment of the Bankruptcy Code.

69. Ed Flynn, Statistical Analysis of Chapter 11, Ernst & Young Study for Administrative Office of the U.S. Courts 35 (October 1989) (unpublished manuscript, on file with author).

70. *Id.* at 34.

hold only a small fraction of the equity, the deviation from priority may be insufficient.

Fifth, and more generally, the analysis does no more than suggest that a deviation from absolute priority might be useful. Putting it in the Bankruptcy Code makes this a mandatory part of the relevant legal regime. Creditors could negotiate directly with managers for the services they provide and express contracts could be signed and this may weaken the case for doing this through a deviation from absolute priority. Or it may not. I have suggested that having the managers file voluntarily addresses the collective action and information problems that the creditors would otherwise face. They would run into those problems at contracting time if the Bankruptcy Code did not solve the problem for them. I regard it as an open question as to whether those problems would suffice to justify such a rule in bankruptcy.

Finally, we might try sticks instead of carrots; many countries do. In Germany, directors of an insolvent joint stock company or limited liability company have a duty to initiate insolvency proceedings. Failure to comply may result in liability for damages, fines, or imprisonment.[71] In the United Kingdom, the Insolvency Act of 1986 added the concept of wrongful trading.[72] A director that knows or should have known that the company could not avoid going into liquidation and allowed it to continue to operate may be forced to

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71. The laws applicable to the Gesellschaft mit beschraenkter Haftung (GmbH), the primary business entity in Germany, include the following relating to the duties of managing directors:

> § 64(1): If the company becomes insolvent, the managing directors shall file a petition for the institution of bankruptcy proceedings or for the institution of judicial composition proceedings without undue delay, however, at the latest within three weeks from date on which the insolvency has occurred. This shall apply accordingly if the assets of the company no longer cover its liabilities. It will not be considered as culpable delay of the petition if the managing directors pursue the institution of the judicial composition proceedings with the diligence of an orderly businessman.
>
> . . . .
>
> § 84(1): A prison term of up to three years or a fine shall be imposed upon a person who:
>
> 1. as managing director contrary to § 64(1), or as liquidator contrary to § 71(2), fails to file a petition for the instituting of bankruptcy proceedings or of judicial composition proceedings in the event of insolvency or of overindebtedness.
> 2. If the person acts negligently, then the penalty shall be a prison term of up to one year or a fine.

4 (Statutory Materials) BUSINESS TRANSACTIONS IN GERMANY App. 6-34, App. 6-42 (Bernd Rüster, ed., 1991); *see also* Horst M. Johlke, *Circumstances in which Proceedings of Bankruptcy/Winding up may be Initiated in Germany*, 10 INT'L BUS. LAW. 34, 35 (1982).

72. *See* Insolvency Act of 1986 § 214.

contribute to the debtor's assets.[73] And, under the Company Directors Disqualification Act of 1986, such a director may also be disqualified for a period of years from the management of other companies.[74]

The choice between carrots and sticks should be guided by the ex ante consequences of the different rules. Penalties that do not run to the direct benefit of creditors, such as fines, imprisonment, or disqualification going forward, may just dampen entrepreneurial initiative. Unless we think too many projects are started, we might be better served by a bonus scheme that had the same effect on inducing petition filings. Penalties that do run in favor of the creditors may also be less efficient than bonuses if manager-shareholders are systematically more risk averse than creditors. A bonus scheme acts as insurance, while a penalty scheme exacerbates the substantial losses already suffered by poorly diversified insiders. Monetary penalties also may be meaningless if the manager is insolvent herself. Another benefit of carrots is that managers seek carrots; they run from sticks. Someone will have to play policeman—quite literally in Germany—to enforce penalties and that adds an extra layer of costs.

IV. CONCLUSION

The two key elements of the implicit bargain between secured and unsecured creditors are priority for secured creditors to the extent of their debts and pro rata division of the balance among unsecured creditors. Collective action and information problems put this deal at risk.

Most typically, the secured creditor may cheat on the deal by keeping the excess amount. The unsecured creditors will not know whether the secured creditor's failure to turn over money reflects the true state of the world—the unsecured creditors were entitled to nothing—or cheating by the second creditor given the actual state of the world.

The party best situated to know is the debtor. The debtor receives notice from the secured creditor of its intentions under the relevant statutes and also has the most particular knowledge of the property. With the firm insolvent, the debtor may pay too little attention to the secured creditor. To make the debtor pay attention, we must change its incentives. This can be done through penalties,

73. *See* Paul R. Ellington & Ian M. Fletcher, *Responsibilities and Liabilities of Directors and Officers of Insolvent Corporations in the UK,* 16 INT'L BUS. LAW. 491, 492 (1988); Jonathan M. Lewis & Jonathan E.F. Rushworth, *Creditors' Rights and Risks by Financing During a Company Crisis: The Law and Practice In England and Wales,* 18 INT'L BUS. LAW. 62, 65 (1990).

74. *See* Ellington & Fletcher, *supra* note 73, at 494.

though this has problems, or through bonuses. The current Bankruptcy Code allows the debtor to select a bonus by filing for bankruptcy. The procedural holdup the Code allows translates into an ability to extract value from the creditors. This leads to the systematic deviations from absolute priority found in practice. These are tempered by the right of the secured creditor to seek relief from the stay. In a pristine system, the stay hearing would seek to determine the relevant state of the world, to identify whether there was value available for unsecured creditors. It is that question which must be answered if we are to implement fully the implicit bargain struck between secured and unsecured creditors.